

**LOCAL FINANCE  
IN THE SLOVAK REPUBLIC:  
AN UPDATE**

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## **ABSTRACT**

**In early 1993, Robert Firestine investigated the municipal finance system of the Slovak Republic under the ICMA Consortium's Local Government and Housing contract with USAID. Firestine's report, *Local Finance in the Slovak Republic*, provided an important foundation for subsequent training and technical assistance efforts. This report updates Firestine's earlier investigation using data collected in June, 1994. Specifically, its purpose is threefold:**

**To report on the implementation of 1993 municipal finance reform, and how municipal budgets performed under the new system compared to expectations.**

**To assess the outlook for Slovak municipal finances in 1994 and beyond including the impact of ongoing changes to the revenue-sharing system.**

**And, to recommend areas of possible assistance by USAID in light of these findings.**

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## EXECUTIVE SUMMARY

### Background

The Slovak Republic instituted a new municipal finance system beginning in 1993. This new system cut municipal subsidies traditionally provided by the state, and in their place established a scheme for revenue-sharing between the state and local governments. Other features of the new system included a property tax and an anticipated increase in revenues from the sale of municipal assets. At the time there were concerns about the immediate and longer term impacts of the new system. For example, would revenues under the new system be sufficient to meet increasing responsibilities being placed on Slovak municipalities? And, would the new system provide a more predictable flow of revenues and thereby improve municipal capacity to budget effectively?

As in previous years, actual revenues and expenditures in 1993 outstripped budgeted amounts by a margin of almost 2 to 1. Between 1992 and 1993 aggregate municipal revenues *increased* while expenditures *decreased*, and, as a result, the overall budget surplus recorded by Slovak municipalities rose from Sk 0.96 billion to Sk 1.67 billion. This figure is misleading. The way in which municipalities treat loans in their financial statements overstates the surplus for 1993. Municipalities report loan proceeds as revenues for the year in which they borrowed the funds. This has the effect of inflating total income in that year. It also ignores the effect in subsequent years when loan repayments generate additional expenditures. In the face of unpredictable revenues, municipalities have become very active selling or pledging their assets as collateral for loans to meet growing demands for services and investments. Loans are becoming a major source of cash that allows local financial managers to compensate for the constant variations in the revenues they receive from the state. Total borrowing by municipalities in 1993 may have exceeded Sk 720 million.

Concerned with the growing national deficit in the face of an apparent municipal surplus, the Ministry of Finance instituted new changes in the tax revenue sharing rules late in 1993. With their future revenues once again based on untested rules, municipalities were unable to budget with any precision for 1994.

Case studies of two communities discussed in Firestine's report--Trencin and Banska Bystrica--and a third municipality, Detva, illustrate and confirm the trends observed in the aggregate data for all municipalities.

### Summary of Findings and Recommendations

*Municipal revenues are unstable and unpredictable.* Slovak municipalities will confront challenging problems managing their finances over the next several years. Revenues are unstable and unpredictable. The parliament has changed the rules for sharing national tax revenues with the municipalities several times in recent years. The absence of stable rules of the game makes it extremely difficult for the municipal budget directors to estimate revenues from state taxes.

*Municipal borrowing is becoming increasingly important.* The cities have been more successful using their property as collateral for loans from private banks. This is becoming a major source of revenues. It is also the element that allows local financial managers to compensate for the constant variations in the revenues they receive from the state. Municipal officials may not appreciate fully the difference between borrowed funds and recurring income, such as tax revenues. This is a cause for concern.

*Municipalities have been successful controlling expenditures.* Aggregate national municipal non-investment expenditures increased by 5% from 1992 to 1993. These aggregate national results are impressive in the light of an estimated annualized inflation rate of 25% for 1993. Expectations for 1994 are mixed. While there still is further room to reduce subsidies to municipal enterprises, this category is becoming less significant in the total expenditure picture. On the other hand, debt service is becoming an ever more significant component of municipal expenditures. Municipal officials may not be sensitive to the full implications of this trend.

The analysis done for this report suggests two possible areas for providing assistance to support the efforts of the municipalities:

- Technical assistance to the Ministry of Finance to explore options that might give the municipalities greater control over their revenues
- Training and technical assistance to the municipalities in financial management concepts and skills with emphasis on the need to improve accounting practices and financial reporting.

There are two other possible areas of assistance which could provide a significant boost to municipal finances. These recommendations are only of a general nature. They derive indirectly from the findings of this report. The two areas are:

- Technical assistance to the national government to create an enabling framework for a national real estate market. Such a market would greatly facilitate the establishment of a value-based municipal property tax system.
- Training and technical assistance to the growing municipal bond market

*Keeping the assistance focused.* The proposed assistance program need not become extensive and expensive. Support for broad national reforms to create an enabling framework for municipal fiscal autonomy and for real estate and municipal bond markets should not require large or new efforts. This is an area where the United States has a comparative advantage. It also is an area in which USAID has experience in other parts of Eastern Europe. Narrowly-targeted assistance can have broad impacts.

## 1. NATIONAL OVERVIEW

~~When he prepared his report, the outlook for 1993 municipal budgets was unclear. On the one hand, there was good reason to believe projections for 1993 were unrealistically low because actual revenues and expenditures had consistently outstripped budgeted amounts in previous years. On the other hand, a number of factors threatened to undermine municipal revenue-generating capacity. Potential threats included:~~

- **Limited revenue from state subsidies and municipal borrowing.** These resources accounted for a major portion of unanticipated revenue in 1992, but could they be expected to make a similar contribution in 1993?

- **Limited revenue from the new property tax.** Firestine predicted considerable procedural and administrative problems with collection of this tax as a result of, among other things, inaccurate property ownership records and legal complications related to denationalization and restitution of state assets. Would property owners pay the tax (given that it was a new and relative small levy), and, if they did, would administrative bodies set up to collect the tax be sufficient?

- **Limited revenue from the sale of municipal assets.** Under the new finance system municipalities expected to raise an increased share of "own" revenues from this source. Given municipalities' poor track record with the sale of housing units, were these expectations realistic?

- **Limited revenue from shared state taxes.** Firestine raised concerns about the national economy's impact on municipal income from revenue-sharing. Would economic problems at the state level deflate municipal revenue from the tax on dependent income?

~~Actual revenues and expenditures in 1993~~ for Slovak municipalities did not bear out concerns about municipal revenue-generating capacity. As in previous years, 1993 actual revenues and expenditures outstripped budgeted amounts by a margin of almost 2 to 1. Between 1992 and 1993 aggregate municipal revenues *increased* while expenditures *decreased*, and, as a result, the overall budget surplus recorded by Slovak municipalities rose from Sk 0.96 billion to Sk 1.67 billion.

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The Ministry of Finance and the municipalities use the term "revenues" to include all sources of cash, including loan proceeds. It is true for "expenditures", which seem to include all uses of cash, including loan amortization. This is not standard practice. Government, for example, treats "revenues" and "loan proceeds" as separate items. Slovak municipal income statements are more like a cash flow, showing all sources and application of cash. The absence of more traditional financial statements makes it difficult to obtain an accurate picture on the performance and status of municipal finances.

*Revenues.* **Actual revenues outstripped budgeted revenues in all major categories, and, overall, actual revenue exceeded budget by Sk 9.83 billion. As Table 1 indicates, some revenue categories were more important than others in making up this surplus. This reflects initiatives by municipal governments to mobilize additional funds rather than a dependence on state assistance.**

Table 2  
Overall Municipal Revenues in the Slovak Republic  
Initially Budgeted and Actual, 1992-1994  
(in Sk billions)

	<u>1992</u>		<u>1993</u>		<u>1994</u>
	Budget	Actual	Budget	Actual	Budget
<u>Local taxes and fees</u>	<u>2.31</u>	<u>3.45</u>	<u>3.40</u>	<u>3.69</u>	<u>3.85</u>
House tax	.12	.13	-	-	-
Tax from agricultural land	.03	.06	-	-	-
Property tax	-	-	2.70	1.61	2.30
Tax on entrepreneurial income	1.08	1.46	-	-	-
Local fees	1.02	1.69	.62	.69	.70
Administrative and other fees	.06	.11	.08	.16	.85
<u>Revenues from municipal assets</u>	<u>.71</u>	<u>1</u>	<u>.80</u>	<u>1</u>	<u>.20</u>
	<u>.35</u>	<u>2</u>	<u>.25</u>		
Earnings tax from mun ent's	.06		.15	-	-
Payments on financial plan	.00		.04	-	-
Tax on wages of mun employees	.25		.36	-	-
Revenues of municipal organizations	.35	1	.03		.50
	.95	1	.15		
Revenues from property sales	-	-	.70	1.90	1.00
Rent	.05	.23	-	.50	.10
<u>Shared taxes from state</u>	<u>4.74</u>	<u>4.20</u>	<u>4.74</u>	<u>5.65</u>	<u>4.23</u>
Share of wage taxes	3.27	3.52	-	-	-
Share of tax on agr. incomes	1.46	.68	-	-	-
Share of tax on dep. income	-	-	4.74	5.65	2.21
Share of tax on legal persons	-	-	-	-	1.51
Share of road tax	-	-	-	-	.50
<u>Other revenues</u>	<u>-</u>	<u>4.54</u>	<u>.28</u>	<u>5.05</u>	<u>1.4</u>
<b>TOTAL "OWN" REVENUES</b>	<b>7.75</b>	<b>14.00</b>	<b>9.61</b>	<b>18.74</b>	<b>11.73</b>
Non-specific subsidies	.21	.20	-	-	-
Specific subsidies:					
To operate housing agencies	.30	.24	-	-	-
To complete housing complexes	-	4.20	-	.65	-
Urban transit operating sub's	1.10	1.09	.88	.88	.58
Urban transit capital sub's	.85	.85	.43	.43	.24
Municipal self-admin; and other	-	.05	.21	.27	.22
<b>TOTAL STATE SUBSIDIES</b>	<b>2.45</b>	<b>6.63</b>	<b>1.52</b>	<b>2.23</b>	<b>1.04</b>
<b>TOTAL REVENUES</b>	<b>10.21</b>	<b>20.63</b>	<b>11.14</b>	<b>20.97</b>	<b>12.76</b>

Source: Department of State Administration and Self-Government, Ministry of Finance, Slovak Republic



The largest single share of unanticipated revenues fall in a broad, undefined category called "other own revenues" (51.3 percent). The category includes the proceeds from loans obtained by the municipalities. In the three cities reviewed in greater detail for this report, loan proceeds accounted for 100% of the revenues in this category. This suggests that short-term municipal borrowing is now a permanent component and important tool in municipal budgets. It also is an element that is distorting the overall picture of municipal finances because of the treatment given to loans in municipal financial statements. Municipalities report loan proceeds as revenues for the year in which they borrowed the funds. This has the effect of inflating total income in that year. It also ignores the effect in subsequent years when loan repayments generate additional expenditures. Existing estimates on overall municipal borrowing are not nearly high enough to account for the Sk 5.05 billion in "other own revenues." The Ministry of Finance did not provide any additional data to explain what other sources might be included in the figure. This is an area that warrants closer attention in a future analysis of Slovakian municipal finances.

Revenue from municipal assets was another major, locally-generated, source of unanticipated funds (32.1 percent). As Table 2 indicates, all three subcategories here-- revenue from budgetary and contributory organizations, property sales, and rent--made

**gains. It is noteworthy that property sales generated more than twice as much revenue as expected, in spite of earlier misgivings about potential revenue from this source.**

**Actual revenues from the local taxes and fees category roughly matched budgeted amount, but only because lower-than-expected revenues from the new property tax were offset by additional revenues from local and administrative fees. Again this points to the importance of local initiative in securing revenues: municipalities have considerable latitude to modify the local fees structure, but the property tax is levied at nationally-established rates. This also substantiates Firestine's concerns about the administrative and legal barriers to realizing the full potential of the property tax. After all, the property tax was the only revenue source that came in under budget at the aggregate national level.**

**Only a small part of the surplus of actual versus budgeted revenues was made up by additional state resources. The newly-introduced municipal share of the state tax on dependent income<sup>2</sup> accounted for 9.3 percent of total unanticipated revenue, although, as indicated by Table 2, it was the largest single revenue source in terms of absolute amount.**

**Finally, as Firestine predicted, in 1993 the state did not assist municipalities with unanticipated subsidies--at least not to the same extent as 1992. Unanticipated state subsidies accounted for 7 percent of the total revenue surplus including Sk 0.65 billion for completion of housing complexes. Since the state reportedly discontinued subsidies for this purpose in 1993, this sum may represent an un-spent appropriation from the previous year rather than additional state effort to help municipalities meet revenue needs.**

*Expenditures.* **The difference between budgeted and actual expenditures was similar in 1993 to 1992 with actual amounts exceeding a conservative original budget by a considerable margin (see Table 3). Unanticipated expenditures were split between investment and non-investment categories in approximately even shares.**

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<sup>2</sup>This is the term used in the Slovak Republic for the tax on the income of citizens, or what we would call the income tax.

Table 3

**Overall Municipal Expenditures in the Slovak Republic  
Initially Budgeted and Actual, 1992-1994  
(in Sk billions)**

	<u>1992</u>		<u>1993</u>		<u>1994</u>
	Budget	Actual	Budget	Actual	Budget
<b>Administration functions</b> (incl. self-administration, contracted services, and budgetary and contributory org's)	<u>5.89</u>	<u>10.32</u>	<u>7.32</u>	<u>11.06</u>	<u>9.35</u>
<b>Subsidies to mun enterprises:</b>	<u>1.39</u>	<u>1.38</u>	<u>.88</u>	<u>.98</u>	<u>.58</u>
Operation of housing agencies	.30	.29	-	-	-
Urban transit operating sub's	1.10	1.09	.88	.98	.58
<b>Financial operations</b> (incl. interest & principal payment)	<u>.08</u>	<u>.42</u>	<u>.09</u>	<u>.66</u>	<u>.37</u>
<b>TOTAL NON-INVESTMENT EXPENDITURES</b>	7.36	12.12	8.28	12.72	10.30
<b>Investment expenditures:</b>					
Completion of housing complexes	-	4.20	-	?	-
Development programs	2.00	2.50	2.42	?	2.24
Urban transit capital sub's	.85	.85	.43	?	.24
<b>TOTAL INVESTMENT EXPENDITURES</b>	2.85	7.55	2.85	6.58	2.48
<b>TOTAL EXPENDITURES</b>	10.21	19.67	11.14	19.30	12.76

Source: Department of State Administration and Self-Government, Ministry of Finance, Slovak Republic

As noted above, 1993 saw a reduction in actual expenditures compared to 1992. Mainly this reduction was made at the expense of investment expenditures as opposed to municipal operations costs. As Table 3 shows, actual investment expenditures declined from 1992 to 1993 while non-investment expenditures increased marginally over the same period.

Of all expenditure categories, expenditures for administrative functions saw the biggest increase in absolute terms between 1992 and 1993. Unfortunately, we do not know what share of this increase is attributable to municipal outlays for self-administration versus contracted services or budgetary and contributory organizations.

As noted above, budgetary and contributory organizations produced more revenue than anticipated in 1993, but this surplus may have been more than offset by increased municipal outlays to these organizations. Our discussion of finances in different municipalities highlights the potential drain budgetary and contributory organizations can be on municipal resources.

It is noteworthy that a relatively small share of aggregate expenditures go for financial operations. This category includes payments for principal and interest on municipal loans, and, if municipalities continue to rely on private finance as a major source of revenues, we would expect this line item to claim an ever-increasing share of municipal budgets. In 1993, only 6 percent of total non-investment expenditures was spent on this expenditure category. In proportionate terms, though, this expenditure item saw the largest growth from 1992 to 1993--almost a 60 percent increase from Sk 0.42 billion. The case studies below illustrate the upward pressure on this particular expenditure item.

~~One of the goals of the 1994 investigation~~ Prospective goal for the 1994 investigation was to look at how municipalities would react to the better predictability of revenues in the second year after municipal finance reform. Unfortunately, <sup>new</sup> changes to the Republic's municipal finance system in 1994 have made this issue irrelevant. New municipal finance system reforms include:

- Reduction in the share of the tax on dependent income distributed to municipalities--down to 30 percent from 70 percent in 1993.
- Introduction of a six percent municipal share of the state tax on legal persons--corporate tax.
- Introduction of a 30 percent municipal share of the state road tax--a tax on commercial vehicles.

Because municipalities have to deal with a new revenue-sharing system, it is not surprising that planned budgets for the 1994 budget cycle display the same conservatism as 1993 and before. To start, the new changes have perpetuated the unpredictability of municipal revenues, so, like 1993, budgeted revenues and expenditures for 1994 are close to the budgeted amount (rather than actual amount) for the previous year. Municipal budgets initially provide for essential expenditures and use conservative estimates of revenue. As in previous years, non-essential investment expenditures are largely excluded from 1994 municipal budgets. In fact, at Sk 2.48 billion investment expenditures account for a smaller share of total budgeted expenditures in 1994 than 1993.

The new method for distributing shared state taxes may have a differential impact, with some communities being net winners and other net losers. Whereas the tax on dependent income was (and is) distributed to municipalities on a strict national per capita basis (what one respondent called a "solidarity distribution"), the new municipal shares of the tax on legal persons and road tax may benefit some

municipalities more than others. The municipal share of the tax on legal persons will be distributed on a national per capita basis but with a special coefficient to increase revenue for larger communities. This will favor communities where a disproportionate share of the negative externalities associated with doing business can be found. The road tax will be distributed on a per capita basis district by district, thereby favoring municipalities in areas with higher traffic loads.

Perhaps the most important impact of the new changes to the revenue-sharing system will be an aggregate decrease in resources available for municipal budgets. In fact, this possibility was part of the reasoning behind the changes. Because municipalities continue to carry a budget surplus while the state government has a budget deficit, the Ministry of Finance was interested in redistributing resources back to the state. There is disagreement about how much redistribution will occur but little doubt that municipalities will receive fewer shared taxes under the new system.

In the short term, a reduction in municipal revenues from the state will force a reduction in expenditures, an increase in local revenue-generating initiatives, or some combination of both. While there will likely be continued downward pressure on investment expenditures, the previous discussion about budgetary performance in 1993 suggests that municipalities will find a way to cope. Municipalities have shown that in the short run they can be effective generating additional resources from sources that are within their control. Increasingly, this includes funds borrowed from the private financial markets.

In the long-run, whether the municipalities will have the resources they need to meet local demand for investment and services will depend to a large extent on national policy changes. On the revenue side, national policies governing municipal "own" source income--for example, the state mandated property tax rate--must be modified if local jurisdictions are to have sufficient latitude in generating revenue. Municipalities cannot continue indefinitely using the proceeds of the sale of assets and of loans to compensate for changes in national rules on shared tax revenues. There are limited assets available to sell. Access to loans should be used to support investment, not as a cash management tool to offset unpredictable fluctuations in transfers from the national government.

On the expenditure side, the capacity of municipalities to accommodate the loss of state revenue will depend on what additional responsibilities the state transfers to the local domain. Reportedly, municipal governments will become increasingly responsible for Slovakia's health and education systems. Past experience suggests that new revenues may not compensate fully for the new expenditures in these two areas. If so, municipalities can expect an enormous increase in the fiscal burden they have to bear.

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According to officials of the Municipal Development Bank, the Union of Towns and Cities, among others, anticipates revenues will be much lower than projected by the Ministry of Finance.

Table 4

**Municipal Expenditures in Trenčin**  
Initially Budgeted and Actual, 1992-1994  
(in Sk millions)

*Local Finance in the Slovak Republic: An Update*

1992

1993

1994

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	Budget	Actual	Budget	Actual	Budget
<b>Administration Functions</b>	<b>68.7</b>	<b>103.4</b>	<b>98.5</b>	<b>111.5</b>	<b>65.7</b>
Self admin. & contracted services	31.4	36.5	44.1	43.2	30.7
Budgetary and cntbtry org's	31.3	66.9	54.4	68.2	35.0
<b>Subsidies to mun enterprises</b>	<b>3.5</b>	<b>7.9</b>	<b>--</b>	<b>--</b>	<b>--</b>
Operation of housing agencies	--	5.3	--	--	--
Sale of housing prdctn units	3.5	2.6	--	--	--
<b>Financial (banking) operations</b>	<b>2.0</b>	<b>12.7</b>	<b>30.0</b>	<b>47.7</b>	<b>44.0</b>
Interest & principal payment	--	--	30.0	34.3	40.0
Other	--	--	--	13.3	4.0
<b>TOTAL NON-INVESTMENT EXPEND'S</b>	<b>74.2</b>	<b>124.0</b>	<b>128.5</b>	<b>159.1</b>	<b>119.7</b>
<b>Investment expenditures</b>	<b>17.5</b>	<b>108.0</b>	<b>43.6</b>	<b>127.2</b>	<b>43.6</b>
To complete housing complexes	--	50.0	--	20.1	--
Development programs	17.5	38.4	43.6	61.8	7.8
Other	--	9.5	--	45.3	35.8
<b>Surplus</b>	<b>2.0</b>	<b>--</b>	<b>--</b>	<b>--</b>	<b>--</b>
<b>TOTAL EXPENDITURES</b>	<b>91.8</b>	<b>232.0</b>	<b>172.1</b>	<b>286.3</b>	<b>163.3</b>

Source: Municipality of Trenčin, Slovak Republic

## 2. MUNICIPAL CASE STUDIES

**Trenčin** The city of Trenčin mirrors many of the national characteristics described above.

Overall, the city's actual revenues and expenditures surpassed budgeted amount by a considerable margin. And, whereas the city had budgeted a small deficit for 1993, in the end it achieved a small surplus. In considering the city's budgetary performance in 1993 and its prospects in 1994 and beyond, a number of items are of particular interest.

Most revenue items in Trenčin performed at or above their 1993 budgeted amounts, including revenue from the state tax on dependent income, state subsidies, and (unlike the

original budget) state tax on profits. The city's expenditures, however, were significantly below budgeted amounts in 1993 and 1994. This was due to a number of factors, including a reduction in the city's capital expenditures and a decrease in the city's social security contributions.

Table 5

**Municipal Revenues in Trenčín**  
**Initially Budgeted and Actual, 1992-1994**  
**(in Sk millions)**

*Local Finance in the Slovak Republic: An Update*

1992

1993

1994

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	Budget	Actual	Budget	Actual	Budget
<b>Local taxes and fees</b>	<b>20.8</b>	<b>48.7</b>	<b>24.0</b>	<b>31.2</b>	<b>30.0</b>
House tax	1.3	1.7	--	--	--
Property tax	--	--	15.0	15.5	16.0
Tax on entrepreneurial income	8.0	22.6	--	--	--
Local fees:	10.0	22.5	7.0	12.1	11.0
Administrative and other fees	1.5	1.9	2.0	3.6	3.0
<b>Revenues from municipal assets</b>	<b>32.4</b>	<b>69.4</b>	<b>66.7</b>	<b>73.3</b>	<b>71.7</b>
Earnings tax from mun ent's	--	5.5	--	--	--
Payments on financial plan	3.5	3.8	--	--	--
Tax on wages of mun employees	1.0	6.8	--	--	--
Lev's of bdgtry, cntbty org's	11.9	19.5	15.7	30.0	0.5
Revenues from property sales	15.0	31.0	29.5	25.8	53.3
Rent	1.0	2.8	21.5	17.5	17.8
<b>Shared taxes from state</b>	<b>36.5</b>	<b>44.9</b>	<b>60.0</b>	<b>68.9</b>	<b>60.0</b>
Share of wage taxes	36.5	44.9	--	--	--
Share of tax on dep. income	--	--	60.0	68.9	37.5
Share of tax on legal persons	--	--	--	--	17.0
Share of road tax	--	--	--	--	5.5
<b>Other revenues</b>	<b>0.1</b>	<b>27.1</b>	<b>3.3</b>	<b>105.9</b>	<b>1.6</b>
<b>TOTAL "OWN" REVENUES</b>	<b>89.7</b>	<b>190.1</b>	<b>153.9</b>	<b>279.3</b>	<b>163.3</b>
Non-specific subsidies	--	--	--	--	--
Specific subsidies:					
To operate housing agencies	0.0	5.3	--	--	--
To complete housing complexes	0.0	50.0	--	6.2	--
Sales of housing prdctn units	--	--	--	--	--
For development programs	--	--	--	--	--
Misc. subsidies	--	1.9	--	1.1	--
<b>TOTAL SUBSIDIES FROM STATE BUDGET</b>	<b>0.0</b>	<b>57.2</b>	<b>--</b>	<b>7.3</b>	<b>--</b>
<b>TOTAL REVENUES</b>	<b>89.7</b>	<b>247.3</b>	<b>153.9</b>	<b>286.6</b>	<b>163.3</b>

Source: Municipality of Trenčín, Slovak Republic

Trenčín faces a challenge in the area of property sales, one category in which 1993 income did not match budgeted amount. This poor performance would not be especially noteworthy except that Trenčín is putting a lot of emphasis on generation of revenues from municipal assets. The Council has endorsed a development strategy that recommends the sale or lease of all city-owned properties other than those required for

essential government services (such as city hall) or those held for strategic purposes. Accordingly, the budgeted revenue from property sales in 1994 is more than twice the actual revenues from this category in 1993. To date, though, Trencin has had limited success liquidating municipal assets. City staff place much of the blame for this shortfall on the lack of credit for prospective buyers--a factor which was out of their control in 1993 and still will be in 1994.

Another challenge for the city is to accommodate the costs and benefits of borrowing. While Firestone's report applauds Trencin's original plan not to borrow funds in 1993, the city ended up borrowing a substantial sum. In fact, income from loans was the largest single revenue item at Sk 70 million (not shown). Municipal loans have become a fixture of Trencin's budgets with important implications both in terms of revenues and expenditures.

Table 6

Municipal Expenditures in Trencin  
Trends in Relative Share of Major Categories of Non-Investment Expenditures  
1992 - 1994

	Percent (%) Breakdown				
	1992		1993		1994
	Budget	Actual	Budget	Actual	Budget
General Administrative Expenses	92.6	83.4	76.7	70.1	63.0%
Subsidies to municipal enterprises	4.7	6.4	--	--	--
Debt service on municipal loans	2.7	10.2	23.3	29.9	37.0
	100.0	100.0	100.0	100.0	100.0

Source: Compiled by the Urban Institute from data provided by the Municipality of Trencin, Slovak Republic

If revenue from municipal loans is excluded, Trencin's actual 1993 revenues would still have exceeded budgeted amount, but this would have had a serious impact on investment expenditures. Originally budgeted at Sk 43.6 million, investment expenditures ended up accounting for Sk 127.2 million. This represented almost a three-fold increase from budgeted to actual amount, which the city could not have incurred without borrowed funds. Municipal loans funded a number of investments, most notably development of the Tatra Hotel--a joint venture with a Canadian group--at a cost of Sk 30 million.



**After investment expenditures, outlays for financial operations saw the next largest increase from budgeted to actual amount. This category includes debt service and therefore is linked closely to the use of loans for investment purposes--i.e. the cost of doing business with borrowed funds. For Trencin, an increasing cost of doing business with municipal loans is the lost opportunity to fund other expenditures. As indicated by Table 6, between 1992 and 1994 outlays for financial operations accounted for an increasing share of non-investment expenditures, crowding out other potential expenditures. This trend is likely to continue. Though Trencin originally did not budget revenues from municipal loans for 1994, city officials report that the city has already secured a loan for Sk 42 million.**

## Banska Bystrica

In 1993, Banska Bystrica managed its budget well. The city's projected and actual results for the year were as follows:

The city appears to be managing its operating expenses effectively. The

Table 7		
Municipal Revenues & Expenditures in Banska Bystrica		
Results for 1993		
(Sk millions)		
	Budget	Actual
Revenues	212.3	212.2
Expenditures	212.3	202.4

Source: Compiled by the Urban Institute from data provided by the Municipality of Banska Bystrica

consolidated cost of city operations, including budgetary and contributory agencies, decreased slightly from Sk 175.1 in 1992 to Sk 173.8 in 1993. Mayor Stanislav Mika explained that the city has been selling or spinning off services that have been a drain on the budget. He used the example of garbage collection and street cleaning. This had been a service provided directly by the city. The unit was abolished. The city now buys the services from private providers at a lower cost. The contributory agencies are the prime target for future privatization. They have been a large drain on the city budget. In 1993, the contributory agencies collected Sk 4.1 million in fees. The city paid Sk 51.8 million to subsidize their operations. In the future, according to the Mayor, the city will set general policy. It will rely on private companies selected competitively to provide services.

Investments by Banska Bystrica also came in below budget. There was an increase of over 40% in investments in the development plan for the city. This is largely street improvements. Banska Bystrica will be celebrating the 50 anniversary of its uprising against the occupying German forces in 1944. This is a historic event commemorated throughout the Slovak Republic. The investments will improve the appearance of the city for the celebrations. The increase in the investments in the development plan was offset by a reduction of 90% in the budget for new housing. There were no new housing starts in 1993.

Banska Bystrica will carry a surplus from one year to the other for the second year in a row. From 1992 to 1993, the surplus was Sk 10.0 million. From 1993 to

Municipal Revenues: Banska Bystrica  
Actual, 1991 - 1993  
Budgeted 1993 - 1994  
(in Sk\$ billions)

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	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	
	Actual	Actual	Budget	Actual	Budget
<b>Local taxes and fees</b>	<b>27.8</b>	<b>74.6</b>	<b>21.3</b>	<b>27.5</b>	<b>30.5</b>
House tax	1.0	1.7	--	--	--
Property tax	--	--	13.0	15.7	18.0
Tax on entrepreneurial income	17.5	56.2	--	--	--
Local fees:	9.3	16.6	8.3	11.8	12.5
Alcohol/tobacco fees	?	?	4.0	2.9	4.0
Administrative and other fees	1.9	2.5	0.6	0.6	0.9
<b>Revenues from municipal assets</b>	<b>31.7</b>	<b>25.4</b>	<b>65.0</b>	<b>33.3</b>	<b>60.9</b>
Other	1.9	--	--	9.8	--
Tax on wages of mun employees	13.1	9.3	--	--	--
Rev's of bdgtry, cntbty org's	13.5	6.4	1.6	4.1	4.2
Revenues from property sales	--	3.3	50.0	11.4	46.9
Rent	3.3	?	13.4	8.0	9.8
<b>Shared taxes from state</b>	<b>46.3</b>	<b>67.7</b>	<b>110.0</b>	<b>114.4</b>	<b>72.9</b>
Share of wage taxes	46.3	67.7	--	--	--
Share of tax on dep. income	--	--	110.0	89.6	26.7
Supplementary taxes from prior tax year	n/a	n/a	n/a	24.8	20.0
Other (corporate taxes, road tax)	n/a	n/a	n/a	n/a	26.2
<b>Other revenues</b>	<b>10.4</b>	<b>22.3</b>	<b>6.0</b>	<b>26.9</b>	<b>6.8</b>
<b>Surplus from previous year</b>	<b>--</b>	<b>--</b>	<b>10.0</b>	<b>10.0</b>	<b>8.5</b>
<b>Bank loans and interest</b>	<b>--</b>	<b>15.8</b>	<b>--</b>	<b>--</b>	<b>30.0</b>
<b>TOTAL "OWN" REVENUES</b>	<b>116.1</b>	<b>205.8</b>	<b>212.3</b>	<b>212.2</b>	<b>209.7</b>
Non-specific subsidies	--	--	--	--	--
Specific subsidies:	103.9	114.0	--	--	--
To operate housing agencies	7.6	7.5	--	--	--
To complete housing complexes	96.3	104.7	--	--	--
Sales of housing prdctn units	--	--	--	--	--
For development programs	--	--	--	--	--
Misc. subsidies	--	1.8	--	--	--
<b>TOTAL STATE SUBSIDIES</b>	<b>104.2</b>	<b>114.0</b>	<b>--</b>	<b>--</b>	<b>--</b>
<b>VENUES</b>	<b>220.3</b>	<b>319.8</b>	<b>212.3</b>	<b>212.2</b>	<b>TOTAL 209.7</b>

Source: Municipality of Banska Bystrica, Slovak Republic

1994, the surplus will be Sk 8.5 million. Notwithstanding, the outlook for 1994 is varied. The city will be hard-pressed to replicate the successful experience of 1993. In his review of the state of the finances of Banska Bystrica in April of 1993, Robert Firestine summarized his findings as follows:

Budgeted and actual revenue outcomes for the Banska Bystrica municipality between 1991 and 1993 show the difficulty of staying within overall budgetary targets as

well as the sometimes extreme unpredictability of revenue flows that contribute to that unhappy result.<sup>5</sup>

Revenues remain unpredictable. Mrs. Olga Snopkova, the Director of the Budget for Banska Bystrica, stated that it "is impossible to predict or know what the [city's] budget will be because Parliament might pass a new law." In fact, that is what occurred.

As described earlier, the rules for sharing national tax revenues with municipal governments changed once again toward the end of 1993. The problem for Mrs. Snopkova and the other municipal authorities is that they have no prior experience on which to base an estimate of the revenues that Banska Bystrica will receive in 1994 under the new rules. Given the uncertainty, they have prudently estimated that shared state tax revenues will be 36% lower than in 1993 (Sk 72,930 versus Sk 114,448).

Property taxes are another area in which national legislation is having an adverse impact on the ability of Banska Bystrica to manage its revenues and hence its budget. These taxes potentially are an important source of revenue. In 1993, the city collected Sk 15 million in property taxes. The 1994 budget projects an increase of 20% to Sk 18 million. This will represent 20% of the revenues that Banska Bystrica imposes and collects directly. Even in this case, though, there are national rules that constrain the city's options. The valuation of property is set for the country as a whole by type of construction. There is no market valuation. The city can only reallocate the overall property tax burden through a "price map." Even this map is subject to approval by the Ministry of Finance (MOF). Banska Bystrica prepared a price map. The MOF approval is pending. The only use the city has found for the map is in helping to appraise any municipal property which it sells.

The biggest challenge that Banska Bystrica faces is with the sale of municipal property. This is a major source of revenues which the city has yet to exploit fully to its advantage. As of December 31, 1993, the city owned property valued at approximately Sk 6.4 billion, as per the national property tax computations. Much of it is necessary for the operation of the city. The city hall, for example, represents nearly 50% of the total. The inventory also includes other property which is not essential to the city. Banska Bystrica owns vacant land, commercial real estate, office buildings and a public housing stock of over 10,800 units. The housing stock alone has a book value of Sk 2.0 billion. The market value of the housing and of many of these properties could be substantially greater than the current book value. Managed properly, these properties could generate a capital fund that would safeguard the financial solvency of Banska Bystrica for years. The city has not been able to realize the full market value of these properties.

National legislation sets the sales price of the public housing stock. It also creates a significant administrative burden. Buyers have a right to an interest-free loan for ten years. The housing stock is not the only problem. Banska Bystrica sold Sk 50 million in property in 1993. It only collected Sk 11.4 million. The balance is in deals that went sour or are yet in process. City officials explained that buyers cannot obtain financing from private banks. This affects all property sales, not just housing. The city has had to act as lender in the sale of commercial sites and of a health center. It has not been very successful. City officials do not like being put in the role of loan collectors. They see it as being in conflict with their municipal functions.

To compensate for the shortfall in sales, the city borrowed Sk 30 million late in 1993. The Tatra Bank provided a two-year loan @ 24%. The lender accepted a lien on two office buildings owned by the city as collateral for the loan. The estimated value of the collateral is Sk 125 million or 417% of the loan amount. Banska Bystrica has had to go to the courts to try to pass the interest charged on this loan through to the buyers of the municipal property. City officials anticipate that it may take as long as one year to complete the process in the courts. In the meantime, Banska Bystrica will have to service the loan from its own revenues. The debt service in 1994 will be Sk 18.0 million. The amount of collateral and the heavy debt service burden prompted the city Budget Director to comment: "I borrowed a bicycle and will have to pay two Mercedes Benz." So far, she is right. The city has received Sk 11.4 million for the properties. It will pay Sk 18 million in 1994 to service the loan.

Table 9  
Municipal Expenditures: Banska Bystrica  
Actual, 1991-1993  
Budgeted 1993 - 1994  
(in Sk\$ billions)

	Actual	1991 Actual	1992 Budget	1993 Actual	1994 Budget
"Non-investment" expenditures, <u>municipal self-administration</u>		97.9	167.7	116.4	102.4
Expenses and contributions to <u>budgetary and contributory organizations</u>				63.6	71.4
Budgetary organizations				23.9	19.6
Contributory organizations				39.7	51.8
( Operation of housing agencies	7.6	7.4	4.0	2.1	-- )
<u>Financial (banking) operations</u>	--	19.2	--	--	18.0
 SUBTOTAL NON-INVESTMENT EXPEND'S	105.5	194.4	180.0	173.8	159.4
 <u>Special grants</u>	--	--	--	--	18.0
<u>Investment expenditures</u>	96.3	114.7	32.3	28.5	46.3
To complete housing complexes	96.3	104.7	10.3	1.0	15.0
Development programs	--	10.0	22.0	27.5	15.0
Other: replacement, renovation	--	--	--	--	16.3
 SUBTOTAL GRANTS/INVESTMENTS	96.3	114.7	32.3	28.5	64.3
 TOTAL EXPENDITURES	201.8	309.1	212.3	202.4	223.7
 TOTAL REVENUES	220.3	319.8	212.3	212.2	209.7
 SURPLUS (DEFICIT)	--	10.7	--	9.8	(14.0)

Source: Municipality of Banska Bystrica, Slovak Republic

The prospects for 1994 with regard to expenditures also are difficult. The budget currently shows a deficit of Sk 14.0 million for next year.

This is less threatening than it appears. Operating expenses will decline for the second year in a row.

From a high of Sk 167.7 million in 1992, the total operating expense budget for 1994 will drop to Sk 96.9 million.

Given the city's success controlling these expenses in 1993, there

is good reason to believe the projections for the coming year. The bulk of the projected expenditures are investments which will more than double. The city can easily postpone many of the investments if it runs into problems on the revenue side.

There is one area for concern with regard to the projected expenditures for 1994. The city estimates that subsidies to contributory organizations will decline by Sk 27.3 million, or over 50%. The city made a one-time working capital contribution in 1993 to a new agency which will manage its portfolio of loans to buyers of municipal property. It anticipates that the agency will pay its way in 1994 at a savings of Sk 17 million. The

balance of the savings will come from the continued campaign to divest of money-losing operations. In 1994, this will include the housing agency, part of the organization that maintains city parks and green areas and small laundries currently run by the city. In 1993, the city housing agency became a limited liability company owned by the City Council. The Budget Director explained that the housing agency is now off-budget. It will not receive any city subsidies in 1994. There is no reason to believe that the agency will pay its way. None of the city officials, including the Mayor, could explain how they will deal with this without drawing on the city budget. In any case, this would only be a small burden. The subsidy paid by Banská Bystrica for housing in 1993 was only Sk 2.1 million. The projected savings from the privatization of maintenance of parks and green areas are about Sk 5 million. It is hard to tell if such reductions are feasible.

Banská Bystrica faces a difficult challenge in 1994. The city administration did an excellent job overcoming similar challenges in 1993. The same careful monitoring of revenues and expenditures may be enough to ensure success once again. The long-term prospects are not as clear. The solution to many of the problems lies outside the control of the city. That is the subject of the last section of this report.

Detva Detva was not one of Firestone's original case studies, but it lends weight to the lessons from Trenčín and Banská Bystrica. Although Detva has a smaller population (and budget) than these other cities, it displays many of the same fiscal characteristics.

Table 10  
Municipal Revenues in Detva  
Initially Budgeted and Actual, 1993-1994  
(in Sk millions)

	<u>1993</u>		<u>1994</u>
	Budget	Actual	Budget
<u>Local taxes and fees</u>	<u>5.17</u>	<u>4.01</u>	<u>5.43</u>
Property tax	3.05	2.36	3.09
Local, Administrative and other fees	2.12	1.65	2.34
<u>Revenues from municipal assets</u>	<u>4.46</u>	<u>4.36</u>	<u>3.90</u>
Lev's of bdgtry, cntbty org's	2.00	1.87	2.00
Revenues from property sales	1.60	1.45	1.00
Rent	0.86	1.04	0.90
<u>Shared taxes from state</u>	<u>18.00</u>	<u>18.84</u>	<u>14.00</u>
Share of tax on dep. income	18.00	18.84	?
Share of tax on legal persons	--	--	?
Share of road tax	--	--	?
<u>Other revenues</u>	<u>6.72</u>	<u>8.01</u>	<u>0.75</u>
<b>TOTAL "OWN" REVENUES</b>	<b>34.35</b>	<b>35.22</b>	<b>24.08</b>
Non-specific subsidies	--	--	--
Specific subsidies:			
To operate housing agencies	--	--	--
To complete housing complexes	--	0.80	--
Sales of housing prdctn units	--	--	--
For development programs	--	--	--
Misc. subsidies	0.06	1.15	0.06
<b>TOTAL SUBSIDIES FROM STATE BUDGET</b>	<b>0.06</b>	<b>1.95</b>	<b>0.06</b>
<b>TOTAL REVENUES</b>	<b>34.41</b>	<b>37.17</b>	<b>24.14</b>

Source: Compiled by the Urban Institute from data provided by the Municipality of Detva, Slovak Republic

Like Banska Bystrica, the city's budgeted revenues and expenditures were very close to actual amounts in 1993 (see Tables 10 and 11). At Sk 37.17 million, 1993 actual revenues out-stripped expected revenues by only Sk 2.76 million, while total expenditures came in marginally *under* budget. The performance of two revenue



categories--the property tax and "other" revenues--are of particular note. In 1993, Detva saw a shortfall in property tax revenue. In this respect, the city differed from Trencin and Banska Bystrica but corresponded with the aggregate national experience. On the other hand, Detva's income from "other" own source revenues surpassed expected levels. Like Banska Bystrica and Trencin, Detva raised unanticipated revenue from a municipal loan to help meet investment expenditure demands.

The city's major investment expenditure demands are related to economic development and housing. Detva was the location of a Cold War era armaments factory which has laid-off 4,000 workers since 1989, and, as a result, the town's unemployment rate is currently about 17 percent. The municipality has undertaken a number of initiatives to improve the local economy. One proposed project would have built a commercial center to take advantage of Detva's strategic location on the road between Kosice and Bratislava. Unfortunately, with design and analysis costs of Sk 3.8 million and development costs of Sk 900 million, the project has not gone forward. No private investors have been forthcoming, and the city cannot afford to proceed using its own investment budget.

Detva has been more successful in mobilizing funds for its other major investment demand, housing. Like other Slovak cities, Detva has had to reconcile diminishing state assistance with increased responsibilities in the housing arena. And, like other cities, Detva has opted to raise necessary revenue from short-term bank loans. In 1993 this included a Sk 4 million loan from the Municipal Development Bank to start a rehabilitation program for the city-owned housing stock recently transferred from the state. The program calls for new insulation in twelve multi-family apartment buildings at a cost of Sk 4.3 million per building. Currently the city cannot afford a further Sk 1.8 million per building to make necessary window replacements.

The 1994 budget for Detva looks very different to the budget for 1993. Faced with decreasing and unpredictable revenues, Detva made very conservative revenue and expenditure estimates. Budgeted revenues and expenditures are both about 70 percent of 1993 budgeted amount. As Table 10 shows, on the revenue side this dramatic change results from a decrease in predicted revenues from shared state taxes, but, more importantly, a deep cut in resources from "other" own source revenues. This category is budgeted at only 11 percent of the 1993 budget level and does not include any new borrowing.

Table 11  
Municipal Expenditures in Detva  
Initially Budgeted and Actual, 1993-1994  
(in Sk millions)

	<u>1993</u>		<u>1994</u>
	Budget	Actual	Budget
<u>Administration Functions</u>	<u>17.52</u>	<u>17.03</u>	<u>17.59</u>
Self admin.			
Contracted services			
Budgetary and cntbtry org's			
<u>Financial (banking) operations</u>	<u>0.35</u>	<u>0.16</u>	<u>1.79</u>
Interest & principal payment			
TOTAL NON-INVESTMENT EXPEND'S	17.87	17.19	19.38
<u>Investment expenditures</u>	<u>15.93</u>	<u>15.86</u>	<u>4.33</u>
To complete housing complexes	--	0.80	--
Development programs and other	15.93	15.06	4.33
TOTAL EXPENDITURES	33.79	33.05	23.71

Source: Compiled by the Urban Institute from data provided by the Municipality of Detva, Slovak Republic

The burden of a shortfall in shared tax and "other" revenue is placed disproportionately on investment expenditures as opposed to non-investment expenditures. In 1994, investment expenditures are budgeted at less than one-third their 1993 level. Meanwhile, outlays for non-investment expenditures are budgeted above 1993 levels. With unpredictable revenues, expenditures for all but essential municipal activities have been slashed.

This is not necessarily cause for concern. Unlike in 1993, we can expect Detva's 1994 actual revenues and expenditures to surpass budgeted amounts by a considerable margin. In fact, by the time this research was conducted, the city had arranged for a Sk 10 million general obligation bond issue which did not appear in original budget estimates. The proceeds from this issue will buoy revenues to their 1993 levels, and support infrastructure investments related to development of new single-family homes. In the long-term, one of the main challenges Detva must face is how to accommodate the costs of an increased and ongoing reliance on private finance. Interest and principal

**outlays for 1994 are budgeted at more than 10 times their 1993 level. Loans are essential for Detva to continue its program of investment expenditures, but at what cost?**

### 3. FINDINGS AND RECOMMENDATIONS

**Findings** *Municipal revenues are unstable and unpredictable. Slovak municipalities will confront challenging problems managing their finances over the next several years. Revenues are unstable and unpredictable. The parliament has changed the rules for sharing national tax revenues with the municipalities several times in recent years. The absence of stable rules of the game makes it extremely difficult for the municipal budget directors to estimate revenues from state taxes. The most recent change took place late in 1993. It appears designed to reduce the municipal share of tax revenues. The Ministry of Finance expressed concern with the fact that the state has been running a budget deficit, while the municipalities as a whole have had a surplus. The MOF projections for 1994 show a reduction of nearly 25% in the resources from state tax revenues available for the municipalities. This reduction is significant because such revenues represented about 30% of total municipal "own" revenues in 1993. The situation may become even more difficult. In 1995, the national government intends to transfer responsibility for health and education to local authorities. The key question is whether the state will provide the resources required to perform these functions.*

Municipalities also are experiencing difficulties with other major sources of revenues. They have little flexibility in managing income from property taxes. Uniform national rules determine the valuation of property for tax purposes. The municipalities can only reallocate the tax burden within their jurisdiction. Their other major source of revenues is to sell or mortgage municipal property. This has great potential because local authorities own valuable properties that are not essential to the operation of the city. Municipalities have had mixed success selling property. The real estate market in general in the Slovak Republic is still in the formative stages. Legislation is incomplete.

Private bank financing for real estate transactions is very scarce. The lack of bank financing has forced the municipalities to become lenders. Buyers also are scarce. Municipalities often deal with local investors who have little business experience. It is difficult to collect from these borrowers. Despite the problems, city officials continue to include the sale of property as a major source of revenues in their budgets.

*Municipal borrowing is becoming increasingly important. The cities have been more successful using their property as collateral for loans from private banks. This is becoming a major source of revenues. It is also the element that allows local financial managers to compensate for the constant variations in the revenues they receive from the state. One source estimates that the Municipal Bank alone made 160 loans to municipalities in 1993 at a total value of Sk 720 million. Since at least two other private banks - Tatra and Istrobanka - also lend to municipalities, the total volume of lending has to be greater. Figure 1 shows the terms of some of these loans.*

Figure 1

Recent Municipal Loans in the Slovak Republic						
Borrower/ Year	Lender	Amount	Term	Int Rate	Collateral	Debt Serv
Banska Bystrica 1993	Tatra Bank	Sk 30 million	2 years	24.0%	Sk 125 million in city ppty	Sk 19 million in 1994
Detva 1993	Mun Dev Bank	Sk 4 million	4 years	17.8%	Sk 8 million	n/a
Detva 1994	Istrobanka	Sk 10 million	3 years	18.0%	General obligation bond	n/a
Zilina 1993	Mun Dev Bank	Sk 100 million	5 years	18.0%	General obligation bond	n/a
Kosice 1995 (Projected)	Istrobanka	n/a	n/a	n/a	Housing revenue bond	n/a

Source: Compiled by the Urban Institute from data provided by municipalities and lending institutions

Borrowing from banks has become an important component of municipal finances in the Slovak Republic. Istrobanka explained that the new Slovak securities law<sup>8</sup> provides that municipal bonds carry an automatic guarantee of all municipal property. For example, the Sk 10 million bond issued by Detva will have a guarantee of Sk 217 million of municipal property. Bond issues are authorized by the National Bank of Slovakia and by the Ministry of Finance. The Ministry of Finance investigates and confirms the financial information that the cities provide. The 1% emission fee on bonds is waived for municipalities. Interest earned by the bonds is taxed at 10% versus the usual 25%. The securities law allows only book entry bonds.

Istrobanka views municipal bonds as second only to state bonds in importance and security. The Detva bond issue apparently is being placed at a very attractive interest rate (18%) because it is in heavy demand among the large private investment funds. There are few securities public or private available for investors in Slovakia. Istrobanka and the Municipal Development Bank believe many private securities are riskier than those issued by the municipalities.

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<sup>8</sup> Istrobanka is a private Slovak bank. Its major stockholders include a large Slovak insurance company, Girocredit (the trian bank) and the city of Bratislava (10%).

On the other hand, discussions with municipal officials and the treatment they give to loans in their financial statements, suggest that municipalities may view loans simply as another available source of funds. Municipalities use loan proceeds indifferently to meet operating expenses or for investment. There is no sense that the process of borrowing is part of a broader capital budgeting process. This leads, for example, to cases such as that of Banská Bystrica which pledged assets worth Sk 125 million as collateral for a Sk 30 million loan used to offset a shortfall in revenues. Slovak municipalities should be able to obtain greater benefits from their successful access to capital markets.

*Municipalities have been successful controlling expenditures.* Aggregate national municipal non-investment expenditures increased by 5% from 1992 to 1993. These aggregate national results are impressive in the light of an estimated annualized inflation rate of 25% for 1993. The investigation in Trenčín, Banská Bystrica and Detva shows that city officials are conscious of the need to control growth in expenditures. They are attacking subsidies to money-losing municipal enterprises aggressively. They appear to be monitoring their own operating expenses closely.

Expectations for 1994 are mixed. While there still is further room to reduce subsidies to municipal enterprises, this category is becoming less significant in the total expenditure picture. On the other hand, debt service is becoming an ever more significant component of municipal expenditures. There is some reason to believe that municipal officials may not be sensitive to the full implications of this trend. Finally, the continuing uncertainty on the revenue side makes it very difficult to plan and control expenses. Municipalities need the comfort of some stability in their revenues if they are to confront the difficult task of balancing their budgets successfully.

Recommendation: Municipalities have shown great initiative in managing their finances. They have no control over a large portion of their revenues. The national government sets the rules for tax revenue sharing and for property taxes. These rules have changed yearly. Municipalities have reacted by turning to those areas of their finances where they have greater control. They have limited the growth of expenditures. As a group, the municipalities had a surplus in 1993. City governments also have turned to their most prized assets, the real estate they own, to compensate for the unpredictable flow of state tax revenues. Municipalities have confronted some difficulties selling properties. They have been much more successful using them as collateral for loans from private banks.

The analysis done for this report suggests two possible areas for providing assistance to support the efforts of the municipalities:

- Technical assistance to the Ministry of Finance to explore options that might give the municipalities greater control over their revenues or at least stabilize the rules governing shared tax revenues

- **Training and technical assistance to the municipalities in financial management concepts and skills to improve accounting practices and financial reporting.**

There are two other possible areas of assistance which could provide a significant boost to municipal finances. These recommendations are only of a general nature. They derive indirectly from the findings of this report. The two areas are:

- **Technical assistance to the national government to create an enabling framework for a national real estate market.**

- **Training and technical assistance for the participants in the growing municipal bond market.**

*Providing municipalities greater control over their revenues.* One year ago Robert Firestone commented about the extreme unpredictability of municipal revenue flows. The situation persists. Municipalities receive roughly 38% of the resources they manage from the national government. The majority of the resources are in the form of a share of national tax revenues. The balance is in the form of subsidies. Municipalities have no control over this process. They also cannot predict what will happen from one year to another. The rules for tax revenue sharing have changed yearly. The most recent changes took place late in 1993. The Ministry of Finance estimates that the latest changes will reduce these revenues by over 25% in 1994. Subsidies also have been declining steadily. The Ministry of Finance projects a further reduction of over 50% in 1994.

The national government had a budget deficit of Sk 23 billion in 1993. The municipalities as a group had a budget surplus of Sk 1.6 billion. In this context, the steps taken by the Ministry of Finance make sense. The country as a whole is running large deficits. It is proper to try to address that problem. The situation is different when seen in the context of municipal needs. Their problem is the uncertainty about their revenues. Municipalities can and will function adequately with fewer resources. They will not manage their finances as effectively if they have to wait most of the budget year to develop a reasonable estimate of their current year revenues. This erodes budget discipline. It complicates planning for staff levels and for investments. It tends to compress expenditures in a just a few months of the year.

The answer is to give municipalities greater control over their revenues. This can come in either of two ways. One would be to stabilize the rules for national government transfers to the municipalities. This is easier said than done, particularly for a government confronting serious deficits. The other way is to enact legislation giving the municipalities direct authority to impose and collect taxes. The choice between these two options is not an easy one. Helping to explore and evaluate these options is the single most important area in which USAID can contribute to the improvement of municipal finances in the Slovak Republic.

*Municipal financial management.* Municipalities confront a constant need to balance unstable and unpredictable revenues with growing needs. They have become active selling or pledging their assets as collateral to enhance their revenues. In this process, accurate financial reporting is vital. Slovak municipalities produce timely and

extensive information on their finances. This information is not as useful as it might be because it is not complete or consistent. Municipalities only prepare income and expense statements. There is some evidence that the municipalities may be mixing income statement and balance sheet items. For example, payment of principal and interest are treated equally as expenditures. There also are important omissions. Both municipal and bank officials spoke of "secondary debt" as a problem of many local authorities. This appears to be an attempt to deal with receivables and payables which the municipalities do not report otherwise. Municipal officials, national government officials and private lenders need to have an accurate picture of both the performance and status of municipal finances. Training and technical assistance to improve accounting practices and financial reporting would be a valuable contribution at this time.

Municipal officials also could profit from training and technical assistance in the management of their existing assets and future investments. The Urban Land Institute helped Trenčín develop a strategy for exploiting its surplus properties, for example. This should be coupled with additional assistance in developing a capital budget for the municipality. Such a budget would identify priority municipal investments and viable options for financing them. It would be useful to develop one or two such cases and follow up on the implementation of the recommendations. The successful experiences could then become the subject of case studies to share with other municipalities. Hopefully, many of the cities will succeed in converting their largely non-producing assets into a capital fund which together with continued access to capital markets will support the future development of the cities and their economies.

*Creating the enabling framework for a real estate market.* Local jurisdictions cannot realize the full value of their properties at present because there is a very limited real estate market. Legislation governing real estate transactions is incomplete. Lending for such transactions is scarce. The public housing stock constitutes the largest asset of the municipalities. Existing USAID technical assistance to the national government in the privatization of housing will provide new options to municipalities in this area. It would be useful to look for other related areas of technical assistance that could contribute to creating a viable real estate market in Slovakia. Such a market could greatly facilitate the establishment of a value-based municipal property tax system.

*Supporting the municipal bond market.* Slovak municipalities are borrowing successfully from domestic capital markets. The larger share of the lending is by a bank owned by the municipalities. The municipality of Detva, among others, has succeeded in obtaining a loan from a private bank. This is a highly promising development. A donor financed municipal fund might help to expand private lending and introduce longer-term lending. The risk is that it could also displace some of the existing lending. This is what the local officials in Trenčín, Banská Bystrica and Detva all hope for - inexpensive, long-term donor financing. They do not like "borrowing a bicycle and paying two Mercedes Benz," as one official put it. Another strategy might be to provide technical assistance to support the existing lending. Such assistance might



**focus on expanding the sources of longer-term funding. Pension funds, or the municipal capital funds generated by the sale of properties, could become such sources. The support to the existing municipal bond market might also help improve risk management, for example, by introducing bond rating or insurance practices based on standardized financial reporting. The proposed training and technical assistance to the municipalities in accounting and financial management would contribute as well to this process.**

*Keeping the assistance focused.* **The proposed assistance program need not become extensive and expensive. Support for broad national reforms to create an enabling framework for municipal fiscal autonomy and for real estate and municipal bond markets should not require large or new efforts. This is an area where the United States has a comparative advantage. It also is an area in which USAID has experience in other parts of Eastern Europe. Narrowly-targeted assistance can have broad impacts.**

**On the municipal side, the strategy should be to continue to work with a few cities. They would provide live examples of the application and of the benefits of the broad reforms. They also would provide "hard" results that would be easy to show as evidence of impact. Given the importance of succeeding, it might be useful to revisit the current list of municipal partners. The idea would be to confirm that they have the commitment and they are willing to take the initiative to make changes and pursue a winning strategy.**